AN OVERVIEW OF THE UNIT TRUST INDUSTRY IN HONG KONG

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ABSTRACT

The major objective of this project is to give an overview of the various characteristics, management, development and trends of the local unit trust industry.

Unit trusts have been one of the most rapidly growing businesses in Hong Kong during the recent years. The economic background, geographical factors, sociological factors, political and psychological factors, together with the active promotion programmes, all contribute to the growth of the market.

While unit trusts possess the advantages of diversification of investment, time saving, professional management and economies of scale in investing, they also have the drawbacks of significant management fees and less control over investments.

Generally speaking, the responsibility of a fund manager can be categorized into internal and external management. Internal management involves mainly the management of the investment portfolios which in turn involves analytical skills and professional expertise. External management primarily involves the promotion of funds.

Most investors only consider returns and neglect the risk level when evaluating fund performance. However, taking risk into account substantially changes the ranking of performance of funds.

Finally, more institutions are likely to enter the fund market and more diversified products will become available in the future. Moreover, as more effort will be placed in promotion, it seems that the business will continue to grow at a fast pace in the foreseeable future.

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ACKNOWLEDGEMENTS

The study represents the students' attempt to understand the characteristics, management, development and trends of the local unit trust industry.

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CHAPTER I

INTRODUCTION

Background

A unit trust is a means for pooling the resources of many investors with common goals. For a low annual fee, investors can enjoy such benefits as daily portfolio monitoring by professionals, a single transaction for broad market coverage and reduced risk through diversification.

The first unit trust in Hong Kong was established in the early 1960's. The late 1970's and the 1980's have been high growth periods for the local unit trust business as both the number and sizes of trusts have grown dramatically. From just four unit trusts registered in the colony in 1960, the industry has grown to over 230 authorised unit trusts and mutual funds as of March, 1987. Locally established trusts manage assets of about HK$23 billion[1] while other trusts and mutual funds manage about HK$45 billion[1] , together making a massive total of HK$68 billion.[1] This large amount of money under management makes the

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[1]"Briefs for Treasurers and Investors," Asian Finance, 15 October 1986, p.29.

territory one of the world's largest areas of unit trust activity.

The tremendous growth of this industry and the ever-increasing potential of the fund market piqued our interest in this research project topic.

Objectives

The objectives of this research project are as follows :

1) To give an overview of the structure of the unit trust industry in Hong Kong.
2) To review the advantages and disadvantages of this investment instrument.
3) To identify the reasons behind the growth of the market in recent years.
4) To look at various aspects of fund management.
5) To shed some light on the relationship between unit trust risk and performance.
6) To highlight the recent development and future trends in the business.

Outline of Study

The report is divided into eight chapters. The first two chapters outline the objectives and methodology employed in this research. The third chapter describes the structure of the unit trust industry in Hong Kong. Then, the various pros and cons of investing in a unit trust are briefly discussed in Chapter 4. The reasons for the boom in the unit trust industry in recent years are also discussed. In Chapter 5, both the theorectical framework for investment analysis and the actual practices of fund management are highlighted.

Most of the unit trust performance comparisons available in Hong Kong now emphasize only returns. It seems that the importance of risk has been neglected. Therefore, we describe briefly various aspects of risk in Chapter 6. We also evaluate the performance of selected funds when taking risk into consideration.

The fund market has been growing at a tremendous pace in the last few years and the growth appears unlikely to slow down in the forseeable future. In order to give a more complete picture of the industry, Chapter 7 is devoted to recent developments and future trends predicted by some of the experienced executives in this field. Lastly, Chapter 8 summarizes the findings of this study.

CHAPTER II

METHODOLOGY AND LIMITATIONS

Methodology

In order to achieve the objectives stated in Chapter One, we obtained data from various sources.

Secondary data

Articles or comments from journals, magazines and newspapers were the sources used to provide the background information. The reports and explanatory memoranda of selected unit trusts, which detail the objectives and the portfolio of the trusts, are the most relevant sources of information for researching management philosophy, methods and performance of the fund managers. Past studies on unit trust performance in Hong Kong were reviewed. Prices of trusts were collected from local newspapers for analysing and evaluating trust performance in different periods. Published materials from some investment consultancy firms also provided valuable information regarding the performance of the funds. Finally, for information concerning the legal control on the industry, the latest released Code on Unit Trust and Mutual Funds was reviewed.

Primary data

Interviews with major fund managers, trust marketing executives and investment consultants were conducted in order to get practical information concerning the management of trusts, their investment decision processes and various aspects of marketing these investment products. These interviews also provided valuable opinions about the reasons for the rapid growth of the market, recent developments and future trends in the fund industry.

Limitations

The major limitations and obstacles that we encountered in completing this reports can be summarized as:

1) Because most of the everyday transactions involved rather complex considerations, it is impossible to identify the decision making process in detail. Moreover, some of the strategies employed by fund managers are 'commercial secrets' which were not disclosed to us.

2) Detailed and comprehensive statistics and figures concerning the performances of various funds are not available in Hong Kong. This caused considerable difficulty in gathering sufficient data to perform a more in-depth analysis of the relationship between risk and performance.

CHAPTER III

THE STRUCTURE OF THE UNIT TRUST INDUSTRY IN HONG KONG

Basically, a unit trust is a pool of funds and a portfolio of securities which is set up by the investment manager and is safeguarded by a trustee. In turn, the ownership of the fractions, or units, of this portfolio are sold to the investing public. The trustee and the investment manager must be separate entities. A trust deed is constituted according to the Code of Unit Trust and Mutual Fund between the investment manager and the trustee. The roles played by both entities as well as by the investors are restricted by the trust deed made between the investment manager and the trustee.

The functions of the important entities of the unit trust industry will be briefly clarified in the following sections.

Manager

As the promoters of the trusts, the managers try to persuade the public to invest its money in their trust. The managers also handle the management, investment, and distribution of the trust and therefore are entitled to charge the trust for their services.

These functions may not be performd by just one company. According to the Code of Unit Trust and Mutual Fund (hereafter called the 'Code'), there should be three separate companies, namely, the management company, the investment advisor, and the distribution company. But the Code also accepts that the three tasks are performed by a single company or by two companies. Trusts in Hong Kong usually involve two companies, a management company and an investment advisor. Although, in most cases, the companies are under the control of the same business group, it is believed that the investors have more confidence in this organizational structure.

As a whole, the managers of the trust are in the position to exercise any initiative that may be necessary for running the trust. They are responsible for the launching of the trust scheme and for the trust's investment policy. They are also responsible for making due provisions to meet expenses of the future management and for the services which they have to provide the unitholders.

The managers have to keep the trust's accounts and prepare the trust's report. At least two reports must be published each year. The managers also choose the investments from a permitted list and vary the securities holdings in the trust at their discretion, so long as they conform to the investment clauses specified in the trust deed. Also, calculating the appropriate unit price of the trust from time to time is an important duty of the managers.

Trustee And Trust Deed

Before the managers can proceed further with launching the trust, they must find a suitable company or corporation to act as a trustee. Usually, the trustee is a bank or a large insurance company. The trust deed will then be set up by the managers, the trustee and their solicitors, and professional accountants working together. All the details of the administration of the trust are incorporated in the trust deed.

In order that the trust be authorized in Hong Kong, the trustee and the trust deed must be acceptable to the Committee on Unit Trusts. The contents of the trust deed should include the restrictions on the investment of deposited property, the method of calculating the offer and redemption prices, the maximum permitted levels of initial charges, the management company's annual fees, and the conditions when the redemption of units trust can be suspended. The deed must also state the control of advertising, audit and circulation of accounts, and the powers of the trustees.

Although the trust deed sets forth the restrictive terms of the contract to which the parties have bound themselves, it also empowers the trustee and the management company acting together to amend the trust deed without consulting the unitholders, so long as the unitholders' interests are not adversely affected.

The trustees do not interfere with the day to day operations of the managers unless the managers have done something which violates the terms in the trust deed or hurts the interests of the unitholders. The trustees are also involved in securities transactions, furnishing the cash for trades, and checking the calculations of unit price and yield from time to time.

Last, but not the least, the trust deed empowers the trustee to dismiss the management company by notification in writing when the management company goes into liquidation or when the trustee has sufficient reason to believe dismissal is beneficial to the investors.

Investors

The customers of unit trusts in Hong Kong include both foreign and local investors. In the 1970's unit trusts were sold mainly to expatriates and institutions. Since the locally managed trusts invest primarily in the Far East area, the foreign investors and the institutions bought the trusts in order to take advantage of the rapidly growing economies of the Far East countries.

In recent years, partly due to the promotion and education provided by investment companies, local investors became aware of the benefits of unit trusts and began to buy this type of invetsment instrument. Small to medium size local companies also became customers of unit trusts. Many of these companies have recently estabilished pension funds or provident fund schemes. These companies do not have large funds and do not have enough experience to invest the funds directly in the market. Naturally, unit trusts are a very suitable channel for their funds. However, they are not suitable for short-term investment because the front-end charges of unit trusts are quite substantial, usually ranging from 2 to 5%.

Unit Prices and Other Charges

There are two prices for units, a bid price and an offer price. Investors can buy units directly from the managers or through the brokers at the offer price while the unitholders may redeem their units from the managers at the bid price.

The prices are calculated at the close of each dealing day or valuation day. Some trusts have their valuation day once a week while others have it every business day. Both bid prices and offer prices are based on the unit's net asset value. The net asset value is computed by subtracting the value of all liabilities from the value of assets and then dividing by the number of units. Portfolio securities are valued according to the methods set out in the trust deed. In general, investments are valued at the mean of bid and offer market prices prevailing at the close of trading on the dealing day. Deposits with banks or deposit-taking companies as well as overnight investments are valued at face value.

The unit offer price includes the unit net asset value at the dealing day, stamp duty, appropriate management charges, estimated selling and buying expenses, accrued income for each unit, and initial charges. The total is then rounded off (always upwards, but not more than 1%).

The bid price equals the sum of unit net asset value and the accrued income minus stamp duty, management charges and other costs. Finally, the total is rounded off (always downwards, but not more than 1%).

The manager's initial charge on application ranges from zero up to 5% of the net asset value. In order to gain an advantage in the competitive environment, some investment companies have launched no load funds in which no initial charge is payable to the managers. Generally, the majority of the initial charges fall between 2% and 5%.

Under the trust deed, the managers are entitled to receive annual charges or management fees normally not exceeding 1.5% of the value of the trust. Out of these fees, the managers are obliged to meet the fees of the investment advisors and all normal expenses, including those related to registration, advisory and secretarial duties, printing, advertising, audit fees, brokerage, and other duties and charges incurred on the acquisition and realisation of investments. The trustee's fees will be paid by the manager out of the management fees.

In umbrella funds, investors can switch their investments among the different trusts under the umbrella fund. Also, for funds offered by some investment companies, investors can enjoy the benefits of shifting their investment in a similiar manner. Normally, the first several conversions, say the first three times, can be effected free of charge at subscription price which excludes the managers' initial charges. However, after the first three conversion tranactions have been undertaken for a unitholder in a calendar year, a charge for administration cost will be assessed by the managers. This includes a reduced initial charge.

Distributions

If the net income, which is comprised of dividends and interest received from the trust's underlying investments less expenses applicable to the trust, is not reinvested, it is usually distributed to unitholders in the form of semi-annual dividends. Nevertheless, the amounts and frequency of such distributions vary according to the investment policy of the trust.

Application for Units and Redemption

Applications to buy or sell units are sent to the managers or any of the appointed distributors of the fund to be forwarded to the managers. Applications are normally made by completing the application form attached to an explanatory memorandum or through telex. A telex application must be confirmed in writing before redemption is permitted. There is a minimum investment size for the unit trust. The minimum subscription amount for most unit trusts is about US$1,000. Units are issued immediately after subscription monies are received by the manager on that day or, if that day is not a dealing day, the next succeeding dealing day at the price calculated at the end of such dealing day.

The redemption value of units is the bid price determined on the day that the redemption application is received or, if the application day is not a dealing day, on the next dealing day. Upon receipt by the manager of a redemption request, the trustee will redeem a sufficient number of units and fractions of a unit to produce the required redemption proceeds.

Reports and Memorandum

At least two financial reports, and preferably four, must be published each year. These reports must be sent to all registered unitholders. If bearer certificates have been issued, the publication of each report must be announced in at least one leading Hong Kong daily newspaper.

Discussion of the economies and the relevant market trends in the investment environment, and the performance of the trust are given in the report. Furthermore, all reports must contain statements showing the assets and the liabilities of the trust. These statements must show the value of each of the assets represented, together with the total deposited property. From the information furnished, the investors may evaluate the composition of the portfolio as well as the manager's management philosophy.

The annual report must also contain the revenue account of the trust and the accounts of the management company relating to transactions in units and the management of the trust. Schedule I and II in Appendix 1 contain the suggested format for these accounts.

Except with the Commissioner's permission, the annual report must be published and distributed within the last four months of the trust's year while semi-annual and quarterly reports must be published within two months of the period they cover.

The memorandum supplies the information about the investment objectives and investment policies of the trust. It also explains the procedures for redemption and subscription, the charging system, and the distribution policy. In effect, the memorandum is a summary of the trust deed. It helps investors to understand this investment vehicle, tells them about their rights and the structure of the unit trust.

To protect investors, no application form or sales literature can be supplied to any person who is not a unitholder unless accompanied by the material that in the Commissioner's opinion supplies sufficient information about the trust. Usually, application forms are furnished in the memorandum.

Investment Restrictions

The investment limitations and prohibitions are given very clearly in the guidance notes of the Code and in the memorandum. The value of the trust's holding of securities issued by any one company, the nominal amount of the trust's holding of any one class of securities of a company, the unquoted investments, the holding of options, gold and silver bullion, and physical commodities are limited. The investment prohibitions restrict the manager from investing in lands, making short sales, guaranteeing any person with respect to borrowed money, or investing in a way that exposes the trust to unlimited liability.

Regulations on Unit Trusts in Hong Kong

Unit trusts and mutual funds are under the control of the Commissioner of Securities. The marketing and operations of trusts are subject to the Securities Ordinance, The Protection of Investor Ordinance, and the Trustee Ordinance. Above all, the main regulations for unit trusts in Hong Kong are contained in The Code on Unit Trust and Mutual Fund administrated by the Committee of Unit Trust and Mutual Fund.

The committee on unit trusts has six members, of which two are nominated by the Commission and two by firms engaged in the unit trust industry. The Commissioner of Securities is chairman of the committee and has voting power. The committee appoints a Secretary who will normally be a member of the staff in the office of the Commissioner of Securities. The Secretary attends the committee's discussions, but has no vote. As the members of the committee are from both the Commission of Securities and the investment companies, the decisions of the committee should reflect the interests of the public as well as those of the industry.

The securities commission requires unit trusts to comply with the Code as a condition of authorization. The Code provides careful definitions of terms, the requirements for the trustee, the trust deed, the management company, the investment advisor, the Hong Kong Representative, and the Explanatory Memorandum. Since the code provides a comprehensive, structured framework for the constitution, operation, and promotion of unit trusts, it has contributed to investors' confidence on this investment vehicle and to the flourishing of the unit trust industry in Hong Kong.

Trust Categories

Customers of unit trusts have become more and more sophisticated. In order to meet their needs, different kinds of unit trusts have been launched. Generally, the unit trusts sold in Hong Kong can be classified into four categories, namely, income, general, growth, and specialised trusts.

The objective of income trusts is to provide a steady and growing income. The portfolio investments of such trusts are fixed-income international and national bonds, certificates of deposits and other money market instruments. The portfolios of most income trusts are diversified among different currencies. Normally, the capital gains realized from the assets are reinvested in the trusts, while the income is distributed annually, semi-annually or quarterly, depending on the distribution policy of the trust.

Balanced trusts aim at diversifying the risks through investments over a wide range of fixed-income securities and equities. Generally, this type of unit trust provides more capital growth but less income to the investors than do income trusts.

Growth trusts are designed to achieve capital growth rather than to generate income. Most trusts launched in Hong Kong fall in this catagory and most concentrate their portfolio investments in Asian countries. International growth funds also invest in the markets of Japan, U.S., U.K. and other European countries.

Specialised trusts invest their money in specific investment sectors with the objective of capital growth. Usually, the trusts select sectors with many different stocks. In Hong Kong, the stocks of firms in commodities, gold, oil, and technology industries are commonly selected as the investment targets of the specialised trusts. Also, a few trusts specialize in small companies.

From the above discussion on the unit trust categories, it seems that a conclusion for the underlying risk level for each category can been drawn. In general, the risk level of income trust will be the lowest with general, growth, and specialised trusts having increasingly higher risk. This generalization does not always hold in practice. The risk level undertaken by an individual trust may change from time to time. Thus, the risk of a trust cannot be determined by just noting its general category. Even trusts falling in the same category or, more specifically, investing in the similar business sectors may show large differences in risk level because the management philosophies of individual fund managers and investment companies differ.

In the later sections of this report, the management of unit trusts, and the relation between the risks and returns of the trust in Hong Kong will be discussed.

CHAPTER IV

THE BOOM IN THE UNIT TRUST INDUSTRY IN HONG KONG

The unit trust industry in Hong Kong has grown very rapidly during the last few years. The number of unit trusts has increased from about 100 in 1984 to more than 200[2] by the end of 1986. There are now approximately 25,000[3] unitholders in Hong Kong while the total assets involved are valued at about HK$70 billion.

In the first part of this chapter, we give a brief discussion of the various benefits and disadvantages of investing in unit trusts. The factors that account for the tremendous growth of this industry are discussed in the second part of the chapter. We categorize the factors into five groups, and examine them one by one.

1) Diversification

In the investments literature, risk is defined as the uncertainty regarding the actual rate of return of an investment. The larger the range of possible

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[2] Hong Kong Economic Journal, 4 October 1986.

[3] Hong Kong Economic Journal, 11 February 1987.

returns, the more uncertainty about the actual return, and therefore the greater the risk. One of the simplest but most widely employed measure of risk is

the variance of return. According to portfolio theory, diversification can reduce or even eliminate non-systematic risk, or so called diversible risk. It is generally assumed that investors are risk-averse. For such investors, diversification is highly desirable because asset pricing theory suggests that bearing non-systematic risk is not expected to earn a higher return.

Unlike most individual investors, unit trusts usually have not less than forty holdings of different equities and in the case of larger funds, the number is in excess of one hundred. This spreading of the risk or diversification avoids the adverse effects that one or two failures could have on a portfolio. Moreover, for international funds, diversification of investments across a number of different markets may further reduce the risk. Therefore, small investors can view unit trusts as 'high return - low risk' instruments.

2) Time saving

For many small investors, keeping a close watch on investments, investment opportunities, and the market is hardly possible. Reading companies' reports, studying economic trends, gathering market information, organizing and analysing information are all time-consuming tasks. However, if one cannot gather sufficient information and undertake appropriate analysis, he may miss some opportunities and even make poor decisions regarding his investments. This has long been a problem for smaller investors.

Fortunately, unit trusts provide a handy alternative for investors. By buying units in such funds, investors can indirectly invest in the financial markets. Investors need only to select the markets they are interested in and can leave the details of transactions and adjustments in the portfolio to those who manage the fund.

3) Professional Management

Even if individual investors can devote the time to study the markets, the investors may lack technical know-how, professional expertise, and various kinds of decision-making assistance. On the other hand, professionally trained unit trust managers, with the assistance of sophisticated decision-support systems and databases, take care of the trust portfolios on a day-to-day basis. More information and analysis, together with experience and expertise, should enable fund managers to make better investment decisions than individual investors.

4) Economies of scale in investing

Most of the transactions in the stock, bond, foreign exchange, and other financial markets involve brokers or dealers who charge for their services. Due to better connections with brokerage firms and a much larger volume of trading, fund managers possess bargaining power and can frequently obtain better terms for services than can individual investors. Lower costs would then result in higher returns for the unit trust holders.

5) Access to more markets

An investor may feel that certain markets are likely to provide favorable returns in the future. However, he may miss the desirable opportunities simply because he cannot access the markets. Since the investment companies ususlly have international connections in different markets, the investor can invest in most of the markets they want through the fund managers.

Of course, unit trusts have some drawbacks and we now provide a brief discussion of the disadvantages.

Disadvantages of Unit Trusts

1) Management fees and the spread of prices

Although some of the unit trusts have had high returns in recent years, the actual return to the unitholders has been less by a significant amount. This is due to the management fees charged by the fund managers and the difference between bid prices and ask prices which can be quite substantial. An example with typical figures will clarify this point. Suppose fund A has done quite well and its annual return is 20%. However, it charges 2% for the management fees and the difference between bid price and ask price is 6%. Therefore, the actual return to an investor who buys Fund A at the beginning of the year and sells it at the end of the year would only be 12%.

In view of the above, one can say that unit trust returns are not as good as they may appear. As a matter of fact, most of the research done on U.S. and other areas including Hong Kong indicates that the performance of unit trusts is slightly below than that of the corresponding markets, probably due to the fees mentioned above.

2) Less control over investments

As the decisions concerning investment in particular instruments and portfolios adjustments are all determined by the fund managers, investors in a unit trust have little direct control over the money they invest. Some investors may consider this to be a disadvantage and may prefer to invest individually according to their own preferences and tastes. Nevertheless, most investors would consider less direct control over their investments to be a minor drawback to investing in unit trusts.

The Reasons Behind the Booming Market

In the following paragraphs, we discuss five major factors that account for the recent rapid development of the unit trust industry in Hong Kong. These factors are the local environmental background, geographical factors, sociological factors, political and psychological factors, and the promotion efforts by participants in the industry.

The Local Environment Background

Hong Kong has long been considered as a paradise for both financial and non-financial investments because of the laisser-faire government policies. The tax legislation is perhaps one of the most attractive in the world. Under existing legislation and practice in Hong Kong, dividend income and interest received by the funds is not liable to tax. Also, there is no capital gains tax in Hong Kong on investments by or in the funds. Hong Kong resident unitholders will not be taxed in Hong Kong on distributions from the funds or on capital gains realized on the sale or redemption of units. All of these tax benefits have made Hong Kong an excellent environment for the growth of this industry.

Apart from the tax benefits, Hong Kong's current regulations are also critical for the development of unit trusts. The painful experience of the bankruptcy of International Overseas Services (IOS) in April of 1970 has been retained deeply in the mind of investors. In order to remove this obstacle to the growth of the fund industry, a number of ordinances have been estabilished to protect the interests of small investors, viz. the Securities Ordinance, Protection of Investor Ordinance and the Code on Unit Trust and Mutual Funds. The ultimate objective is to regulate and guide the setup and management of unit trusts and mutual funds. These regulations are generally considered as mature and flexible by most of the fund managers. Moreover, the monitoring system is also a simple but efficient one.

There is now no control over capital in Hong Kong and hence money and assets can be transferred in and out freely. Because of the advanced and sophisticated telecommunication systems and information networks, one can easily switch his assets all over the world.

Last, but not the least, there is an abundant supply of well-trained and experienced legal professionals who have contributed much to the establishment of the current regulatory framework and also have rendered assistance to the establishment, authorization, and operation of various unit trusts.

Economic Background

To a large extent due to the stability of oil prices, double digit inflation has finally abated. The global economy has gradually entered a period of stable growth. In most countries all over the world, inflation rates and interest rates have fallen substantially, and Hong Kong is no exception.

The reduction in the interest rates has made deposits in banks relatively unattractive. More and more people have begun to look for other means of investing their savings. Unit trusts then become a natural alternative for those without the experience and the time to manage their investments. By taking only a moderate level of risk, investors can earn substantially more than putting the money in a saving account. Moreover, low interest rates have stimulated investment in equity markets. Consequently, there have been bull markets in New York, London, Tokyo and also, Hong Kong. The booming of the securities markets has led to dramatic performance by some of the well-managed unit trusts. This, in turn, has reinforced the popularity of unit trusts.

Geographical Factor

The South East Asia Region is generally considered to be the fastest developing area in the world. Gross Domestic Product (GDP) of Asian countries like Japan, Korea, Taiwan, Hong Kong, China and Singapore are growing at much higher rates than Western countries and other developing countries. With its proximity to these countries, Hong Kong has made itself the home of many unit trusts. It is located in a favourable place to tap the investment potential in Taiwan and Korea, the resource wealth of Malaysia and Australia and the growing economies of ASEAN countries like Singapore, Thailand and Indonesia. Because of sophisticated communication facilities, up-to-date information about all these countries can be available in Hong Kong within minutes.

Sociological Factors

Most of Hong Kong's current population were born after World War II. In the 1970's most people worked hard to buy their own homes and therefore did not have much money to invest. Today, they are approaching their thirties and forties and some of them have finished their 'home-owning plan'. Even for those who are still making payments on home mortgages, surplus saving has allowed them to consider different kinds of investments. They have started to plan for the educational expenses of their children and the own living expenses after retirement.

The younger generation is now entering the expansion stage of their careers. Some of them are busy setting up their own businesses while others are working very hard to get to top positions in their organizations. They simply cannot afford the time to take care of their investments. Moreover, many of them only expect a steady growth of their wealth over the middle or long run and are not willing to take substantial risk. Hence, unit trusts meet their needs exactly.

In recent years, as a result of the government's emphasis on improving the education system, more and more young people have the opportunity to receive more education. Also, as the economy has improved their lot, more families in Hong Kong can afford to send their children abroad. Financial services like personal loans, home mortgages and insurance are products they come across in their daily lives. Consequently, they are more familiar with these new concepts and the unit trust is no exception. This is probably one of the major reasons why so many unitholders are only in their late twenties.

Political And Psychological Factors

Facing the uncertainty associated with the transfer of Hong Kong to China in 1997, quite a number of Hong Kong citizens want to invest overseas. However, with limited capital, it is not easy for small investors to access overseas markets. They cannot even gather up-to-date information on foreign securities markets. However, they may make use of the professional knowledge of the fund managers.

Political uncertainity has also had a great impact on the local stock market. In the past few years, the Hang Seng Index has been extremely sensitive to news released from the Mainland China. For instance, in early 1987, when Mr. Hu Yaobang resigned from his position of The Party General Secretary, the Hang Seng Index lost over 200 points in four days. Similiar events have happened frequently since the Sino-British agreement in 1984. The resulting volatility has made some investors reluctant to invest locally. The unit trusts again provides a handy way to access other profitable and more stable markets like Japan and Singapore.

Promotion

Traditionally, promotion of unit trusts in Hong Kong has been focused on foreign individuals. However, the foreign population accounts for only about 1% of the total population. This is one of the reasons that explain why unit trusts grew so slowly before the 1980's. In the recent years, more and more investment companies have recognized the large potential market among the local Chinese. Most now print Chinese brochures and pamphlets to introduce their various funds. In addition, they make use of Chinese language newspapers and magazines as their advertising media to post unit prices and yields every day. Such actions have proved to be very successful in raising the interest of the general public in unit trusts.

Moreover, the investment companies have used other kinds of tools to promote the advantages of the funds. One of the most successful ones was a large exhibition called "Money' 86" which took place during early September, 1986. This was the first large exhibition of financial services and investments ever to appear in Asia. More than 80 financial institutions from 10 countries participated, and the investment services provided could be classified into 14 catagories including insurance, banking, real estate consultancy, investment consultancy, stock exchange and currencies investment. Among the various products, unit trusts seemed to be the most appealing one and attracted most of the small investors' attention. Through this exhibition, more local citizens came to understand the benefits of investing in unit trusts.[4]

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[4] The Investment Handbook of Hong Kong Money'86.

CHAPTER V

MANAGEMENT

In the first part of this chapter, the fund managers' day to day duties are briefly described. Then the theoretical basis for fund' management is reviewed. Finally, different approaches to investment analysis and the actual practices of fund managers are discussed.

General Description of The Managers' Day To Day Duties

The following is what a typical fund manager who has invested part or all of its funds into the Hong Kong stock market does in his office every business day.

At 7:45 a.m. the fund manager arrives at his office and starts his everyday work with seven or eight newspapers in front of him. These newspapers are chosen mainly according to his own perference. Some of the more popular ones like the Asian Wall Street Journal, the South China Morning Post and the Hong Kong Economic Journal are almost always there.

He then spends one hour or more going through the newspapers. Movements in foreign exchange, equity and bond markets all over the world are his major concerns. He also pays much attention to current events, especially those that alter the economic or political environment and those that affect governments' policies and the investment atmosphere in economically strong countries like the U.S. and Japan. One thing that he will not neglect is sentiment in the markets he is now investing in. The financial gossip columns provide excellent information on this issue.

At 9:00 a.m., after finishing this large amount of reading, he should have a general idea about what has happened since he left the office on the previous day. He is now ready for the meeting with the Account Executives from the Institutional Division and also his colleagues from the Research Division. The main objective of this meeting is to exchange information and opinions. They discuss recent movements in the markets and the reasons behind these movements, and exchange information which they have gathered from their own sources, their analysis, data furnished by their brokers and customers, etc.

Immediately after the first meeting which typically ends at 9:30 a.m., the fund manager attends a second meeting. This time he meets with active market participants, such as dealers and brokers. This is a 'question and answer' period and typically only lasts about 15 to 30 minutes. During this time, he sometimes phones other market participants in order to clarify the market situation.

At 10:00 a.m. the Hong Kong Stock Market begins trading. The manager follows the market closely through an on-line computer terminal on his desk. He also make phone calls frequently to keep in touch with his brokers and to buy or sell securities whenever he thinks that it is appropriate.

At 12:30 p.m. the morning session of Hong Kong Stock Exchanage ends. The manager usually has his lunch with either his colleagues or his major clients. Hence, he frequently does business during the lunch hours.

At 2:30 p.m. the stock market opens again. Thereafter, he basically performs similiar tasks to those in the later part of the morning. Also, he may read reports from his research team or from his brokers. At 3:30 p.m. after the stock market has closed, he can then meet with his clients to answer their questions about fund investments.

At 5:30 p.m. he attends a meeting of his colleagues in the Marketing Division to plan their promotion campaigns for various funds. If he has time, he may go through some of the reports submitted from his research team and brokers, or perform adminstrative tasks. He will probably leave his office at about 7:00 p.m..

We have to emphasize that the above description is a fictitious one. Different fund managers have different practices. In particular, for those fund managers that invest in other markets, the working sequence would definitely be different from that described above. Nonetheless, the fictitious scenario gives us a good feel for the various responsibilities of a fund manager. We can categorize them into two major types: internal management and external management. Most of this chapter focuses on the description of various aspects of internal management. In addition, actual practices of external management will be highlighted in the final part of the chapter.

Internal Management

The internal management is the day-to-day management of the underlying investments undertaken by fund managers in accordance with the policy guidelines laid down by the Directors and with advice from the investment adviser. The major objective of internal management is, of course, to maximize the return on fund investments and, at the same time, manage the risk of loss. In the following paragraphs, we first take a look into the theoretical components of fund management, namely, fundamental analysis, technical analysis, and analysis direction. Then, the practical management components, sources of information and practical approaches are presented.

Fundamental Analysis

The basic foundation of fundamental analysis lies in the belief that the security of every company has its own intrinsic value which can be compared with the market value to determine the appropriate trading action.

Fundamental analysis involves studying basic financial and economic facts about a company issuing a security in order to prepare estimates of the security's value. Analysts study the level and trend of the firm's sales and earnings, the quality of the its products, its competitive position in the market, its labour relations, its sources of raw materials, governmental rules that apply to the firm, and many other factors that may affect the value of the firm's stock.

Typically, they then estimate two numbers: the normalized earnings per share (EPS) and the price earnings ratio (P/E ratio). The EPS is the firm's net income after taxes divided by the number of shares outstanding. The EPS is normalized by adjusting for unusual effects on its value. The P/E ratio is the price per share of a firm's stock divided by the EPS. Then they obtain what is called the value earning ratio (V/E ratio) by dividing the present value per share by the EPS:

$$\text{V/E Ratio} = \frac{\text{Present Value per share}}{\text{EPS}}$$

By comparing the V/E and P/E ratios, fundamental analysts determine whether to buy or to sell. If the P/E ratio is larger than the V/E ratio, the stock is overpriced. Conversely, if the P/E ratio is smaller than the V/E ratio, the stock is underpriced and should be purchased.

Of course, the above description is the most basic theory behind the fundamental analysis and actual application of this technique requires analytical tools and data which are beyond the scope of our research. Basically, the estimate of value involves forecasts of many variables. Some of the most important ones are expected dividends, the risk level and the market rates of interest. The success of fundamental analysis depends to a considerable degree on the accuracy of such forecasts.

Every type of analysis has its own drawbacks, and fundamental analysis is no exception. The analysis is rather complex and it requires a lot of data and time to complete. In addition, some of the factors that affect the performance of the company are rather difficult to quantify or predict. Therefore, at most, the estimated value should be expressed as a range rather than an exact figure. Perhaps the most important drawback of fundamental analysis is that it does not provide decision on timing. It is weakest in short-term forecasting and hence, the appropriate timing for entering or leaving the market.

Technical Analysis

The theoretical foundation of technical analysis rests on three basic premises:

(1) Supply and demand determine the market value of ordinary shares.

(2) The factors affecting supply and demand are complex. These factors influence the market and are reflected in the market values of equities.

(3) Trends in share prices tend to persist for some time. Any changes in these prices are the result of changes in the underlying supply and demand relationship.

The major techniques of technical analysis are chart analysis and mechanical investment strategy.

Chart analysis

The most widely used form of technical analysis is charting, which has the merit of being fairly simple in construction and relatively straightforward in interpretation. These are four basic tyes of chart; line, bar, point and figure, and moving average lines.

1. Line charts

Line charts are the easiest to construct, being simply a graphical record of a given share's daily closing prices. The price is shown on the vertical axis and the time intervals are shown along the horizontal axis.

2. Bar charts

Instead of showing a single price for each time period as in the case of the line chart, bar charts show the actual range of prices at which trading took place during the period. The range is marked by a vertical line, with the closing price of the shares being indicated by a small horizontal line on the right-hand side of the range bar. In addition, bar charts usually contain some indication of the volume of trading in a share.

3. Point and figure charts

For point and figure charts, small price movements are ignored. The chartist's judgement determines what constitutes a small change. The patterns are formed in columns, using Xs for upward movements and Os for downward movements. One column is used as long as an upward or downward movement continues, even if that movement continues over several days. There are no gaps in a column. Each time there is a change in direction, a new column is used. It is possible to project the trend lines from the point and figure charts. Also, congestion areas, wherein share price fluctuate within a narrow range, may be identified.

4. Moving Average Lines

A moving average line is the line that plots the moving average of prices against time. The moving average lines normally constructed are those for 10-days, 50-days and 100-days. By using a moving average line chart and current stock prices, analysts can detect changes in major price trends for individual stocks or for the aggregate market. For instance, the moving average lines would be above the current individual prices when the overall trend has been down.

Mechanical investment strategies

1. Breadth of the market

Breadth of the market measures the difference between net advances and declines of listed shares on a particular exchange. The breadth indicator may give clues to future market direction before a breakout occurs. Its usefulness is supposed to be greatest at market peaks and troughs. At those times, the composite value-weighted or blue-chip dominated market series might be moving in the opposite direction from the majority of individual stocks. Comparing the breadth of the market with the composite market index may identify such situations.

2. Volume of trading

If the volume of trading increases on a day when prices rise and decreases when prices fall, this is considered an overall bullish pattern. When volume begins to fall in a bull market, this is taken as an indication of a general price decrease in the future.

3. Relative strength index

The relative strength technique assumes that stocks which outperform the market in one period will tend to do so in subsequent periods until some major event causes a change in the basic trend. Relative strength ratios for individual stocks are usually computed weekly or monthly. These are ratios of the stock price to an overall market index like the Hang Seng Index. An increase in the ratio over time means that the stock has outperformed the market. According to the relative strength technique, this trend is expected to continue for a time. These ratios can be used for industry analysis, as well as for individual company analysis. This technique should be applied to related stocks or different industries in order to identify the best performers in a group.

Direction of Analysis

In this section, the management approaches to investment analysis are classified in a different manner -- by direction of analysis. There are basially three directions of analysis: "top down", "bottom up", "top down - bottom up".

<u>"Top down" approach</u>

The "top down" approach is perhaps the most natural and logical way of performing security analysis. The analysis starts from the most general macro-factors and then narrows down step by step to the actual selection of securities and the formation of portfolios. In this approach, fund managers first start by examining the global economic and political trends to determine the regions and countries with the highest growth potential. Then they try to identify the most appropriate markets and the most profitable industries. Within the selected industries, the fund managers choose the companies with the best growth potential and overall prospects.

The "top down" approach highlights the individual market sectors in each economy which are likely to benefit most from the perceived trends. As a consequence, the investment areas, sectors, and companies are selected in turn. Although the "top down" approach is widely used, several other approaches are also employed.

"Bottom up" approach

The "bottom up" approach focuses first on identifying individual securities with very high growth potential. Some fund managers like to invest in under-researched issues because of the possibility that the underlying values of the securities have not yet been discovered. Companies which are undervalued in terms of underlying assets, low price/earnings ratios, unrecognised growth potential, or which exhibit a combination of these factors are the investment targets.

"Top down - bottom up" approach

The pure "bottom up" approach is seldom employed. Normally, before actual investment decisions are made, fund managers would have examined the relevant political and economic situation before they pick a particular investment. For example, before investing in the countries with foreign exchange controls, such as Taiwan and South Korea, fund managers have to find out whether they can repatriate their money after selling securities. Also, the managers will consider the political factors when they plan to buy equities in the Philippines, a country recently beset by political unrest. Moveover, the relevant economic trends will have been analysed since the managers are obliged to act prudently to protest the interest of the investors. Thus, the "bottom up" approach is usually combined with some "top down" analysis in practice.

Sources of Information

As information plays a critical role in the investment decision making process, the following section gives an overview of the various sources of information.

Newspapers, magazines, and annual reports

Everyday newspapers like the South China Morning Post, the Asian Wall Street Journal, the Hong Kong Economic Journal and other magazines are excellent sources providing information on the general economic and political situation in the Far East. As noted earlier, fund managers and analysts spend a lot of time reading such publications. Annual reports and other published materials from corporations also give useful information about their businesses, strategies, developments amd financial situation. Other published materials like government annual reports and statistics are valuable information concerning economic trends and governments' policy. All of these materials are useful in providing basic and general information and can be obtained with minimum effort.

Reports from stock brokers

Most of the large brokerage firms like Merrill Lynch and Nomura have very strong research teams continuously doing extensive research and analysis on the various markets and individual securities. In order to maintain good customer relations and to gain more business, brokerage firms supply their analyses to institutional investors including fund managers. Such professional analysis is useful, especially concerning foreign markets. However, these reports are usually rather lengthy. Due to time limitations, most fund managers will first only glance at the report summaries. Only if their interest is piqued by the summary will they go deeper into the report; otherwise, they will switch to other reports.

In-house analysis

Some of the largest investment companies have their own research teams to do in-house analysis. Such a setup may be particularly desirable if the information supplied by brokerage firms does not suit the fund's specific needs. Brokerage firms also may not supply information about certain geographical areas and hence the investment companies must gather their own information through their own network. In-house analysis can be tailored to the requirements of fund managers but, of course, the total management costs involved are likely to be higher with such analysis.

Company write-ups

In order to get more up-to-date information and better estimates of corporations' potential, large investment companies frequently send some of their analysts to visit the corporations. Corporations generally welcome such visits as the investment companies are important potential investors. Analysts will typically talk with the firm's accountants about the financial situation of the company. The analysts may also meet with senior executives to discuss the firm's short-term and long-term strategies, management capabilities and morale. They pay special attention to the growth potential and earning power of the firms. The analysts typically also ask for management's forecast of sales, costs and profits. After organizing and analysing the information gathered, the analysts prepare a company write-up for the fund managers.

Market participants

Successful fund managers typically have some connection with active market participants like dealers and brokers. Frequently, fund managers ask for their opinions and recommendations. With their experience and feeling for the markets, these people can provide up-to-date information to the fund managers.

Practical Approach

In the following paragraphs, we give an overview of the actual practices of many of the fund managers in Hong Kong.

The following is the analytical framework that is generally adopted by investment professionals for making longer-run investment decisions. Not all the investment companies follow every aspect of the following procedures, but nearly all of them use a similiar framework.

The approach can be divided into six major parts as follows:

(1) Determine the constraints and criteria for investment

First of all, the fund manager has to know the amount of money that is expected to be available for investment. Moreover, some investment instruments or techniques are forbidden or restricted either by regulation or by the trust deed. Also, consistent with the nature of the fund, the fund manager has to develop a risk level that he or she should not exceed.

Of course, the constraints and criteria set at this stage would affect the decisions in each of the following stages.

(2) Determine the countries in which to invest

The second step is to determine which

countries to invest in. GNP growth rate, unemployment rate, inflation rate, price index and trade figures of each candidate country are examined to get an overview of the economic growth potential. Apart from this, foreign exchange controls, the tax system and the government's trade policy are all critical factors in determining the feasibility and profitability of investing in a country. Moreover, the political situation is of upmost importance in considering some countries, especially some Asian, African and South American countries. Other important factors include the sensitivity of the country's economy to fluctuations of macro-economic variables like oil prices, interest rates and the strength of currencies of its trading partners.

(3) Determine the markets in which to invest

Once the countries to invest in have been determined, the third step is to choose the markets to invest in among the stock, money, bond market and gold markets, etc. The stock market is by far the most widely chosen by the funds.

The money market includes instruments like Commercial Papers (CP), Certificates of Deposits (CD), Bankers' Acceptances and other financial instruments with maturity of one year or less. Fund managers consider the factors like expected interest rate movements, maturity and marketability of different instruments, and the creditworthiness and default risk of issuers. Similiar considerations are also applied in the case of the bond market. Rate of return, maturity, quality of issuers, rating, liquidity, the yield curve, provision for early redemption and convertibility are the dominant factors in evaluating and choosing bonds.

Considerations in the gold market are somewhat different than those in other markets. Due to gold's very nature, macro-economic variables like inflation, oil prices, interest rates and the strength of US dollar all affect price of gold. Of course, basic supply and demand factors are the determinants of longer-run equilibrium prices.

The first three steps discussed above have general application in the various financial markets. The stages discussed below are applicable to the stock market.

(4) Determine the industries in which to invest

There are many different industrial sectors like banking, trading, manufacturing, utilities, and real estate with shares available in the stock market. Choosing the appropriate industries is the next step in the process.

Analysis to determine the life cycle and growth potential of various industries is typically undertaken. Fund managers and analysts forecast the future supply and demand conditions for various products. In addition, anticipated technological advancements and labour factors are also taken into consideration.

(5) Determine the firms in which to invest

After the fund manager has identified the appropriate industries in which to invest, the next step is to choose companies that are expected to have superior performance in each industry. Financial analysis and traditional security analysis play their roles here.

(6) Portfolio formation

After deciding the appropriate countries, markets, industries and firms, the fund manager finally comes to the stage of setting up the portfolio. This stage can be summarized as matching opportunities with criteria.

Other Findings

Analysis emphasis

Although fundamental analysis, in which securities are analysed in terms of anticipated earnings, interest rate levels, investment trends and investors' sentiment, is the major type of investment analysis, in actual practice technical analysis is still employed to a substantial extent by many fund managers.

Generally speaking, foreign fund managers depend more on fundamental analysis than their local counterparts. On average, foreign fund managers base their investment decisions about 70% on fundamental analysis while local fund mangers weigh both types of analysis about equally.

Since technical analysis is believed to be better in estimating the short-term price pattern, it is widely employed in determining the actual timing of transactions. The fund managers usually use the fundamental approach to help them to identify good investment opportunities and then use technical analysis to select the right time to trade.

Use of portfolio theory and capital market theory

Markowitz Portfolio Theory uses the variance of rate of return as the measure of portfolio risk. Given estimates of expected returns and correlations among the returns on the portfolio assets, the portfolio risk and expected return can be estimated for various possible portfolios. Hence, this technique may be useful for fund managers and to appraise the impact on risk and expected return of possible adjustments to the portfolio. Asset pricing models, such as the Capital Asset Pricing Model (CAPM) and Arbitrage Pricing Theory (APT) are also facets of so-called modern investment theory. They involve a security's Beta coefficient which can be used to estimate the security's expected return.

Theoretically, the methods, theories, and techniques described above are potentially very useful in the investment decision-making process. However, they are not currently being used to any great extent in Hong Kong. Through the discussions with the fund managers in Hong Kong, the authors found that Beta and the CAPM are occasionally used for reference by the managers. The other methods are seldom used. There is no strong evidence that these techniques and methods provide reliable and useful information about Hong Kong stocks. Moreover, much time and effort is needed to gather all information necessary to use the models. In a fast changing investment environment, market timing is very important. Most fund managers find these techniques too cumbersome to be useful in the decision making process.

External Management

Basically, external management as defined here involves external publications and promotion.

External Publications

First of all, fund managers have to calculate the net asset value of the trusts on the dealing day. The calculated value is then used to determine the bid price and offer price published in the South China Morning Post and the Hong Kong Economic Journal every weekday.

Every year at least two reports of the trust must be published. The report includes a general description of the performance of the trust, the related economic trends and forecast, and the income account and balance sheet of the trust. The latest composition of the portfolio is also compiled in the report.

External Promotion

Another important duty of the managers is external promotion. The major activity involved is meeting potential investors and existing customers. Through discussions with clients understanding between both parties can be enhanced. With knowledge about the customers' needs, managers can then determine what other trusts would appeal to the public and should be launched in the future.

Because of their expertise, fund managers are in the best position to convince people to invest in unit trusts. In Hong Kong, although trusts have become more and more popular, most of the local investors or potential customers still do not comprehend the structure, operation, and advantages of trusts. Talking to fund managers is the most direct and simple information channel for those interested in this instrument.

In order to assist their promotion of unit trusts, fund managers write articles in newspapers and magazines about portfolio management, investment recommendations on unit trusts. For example, there is an article by Mr. Duncan Mount of Gartmore (HK) Limited about the performance of a selected portfolio reported in the South China Morning Post every Sunday. This promotion method is indirect but powerful because it reaches a great number of people. Also the image of the manager's expertise can be built up in the readers' mind. When people wish to get information about purchasing unit trusts, they are likely to think of the writers of the articles. These articles also serve to educate the public about unit trusts and hence, contribute to the popularity of this investment vehicle.

The most important promotion program of unit trust is advertising in newspapers and magazines. Although fund managers may not be involved in the detailed design of the advertisements, they do provide suggestions. Basically, the performance of individual trusts, and the performance of all the trusts managed by the investment companies are the most common and powerful means used to promote the trusts.

CHAPTER VI

RISK AND PERFORMANCE

Before individuals or institutions delegate the investment functions to professional portfolio managers (fund managers), they should ask themselves at least two questions. The first question is whether they should try to manage their funds themselves. If they decide that they want somebody else to do the work, they must assess an investment manager's prospective performance to distinguish the good from the bad. This leads to the second question: which investment manager should be selected?

The answer to the first question can be found in the previous sections concerning the advantages and disadvantages of investing in unit trusts. The answer to the second question involves evaluation of performance which, in turn, involves risk and return. The fluctuation of the trusts' risk and returns levels are two main determinants of the performance. Reducing the unsystematic (diversifiable) risks of the portfolio is one of the fund managers' responsibilities. This chapter first describes the risks that will be encountered in the unit trust investments; then it presents findings about the underlying risks of each category of trust; third, it introduces and illustrates some performance evaluation methods.

Risk

Investment Risk

The uncertainty concerning the return of investments is defined as risk. A useful measure of risk is the standard deviation of holding period return (HPR) which can be calculated from the net asset value (NAV) of the trust and information about distributions paid by the fund.

The factors causing the fluctuations of the unit prices are the primary sources of risk. Some factors affect the prices of most securities and are very difficult to reduce. Other factors uniquely affect particular securities. The effects of these factors can be reduced by diversification. These two kinds of risks are referred to as nondiversifiable (systematic) and diversifiable (unsystematic) risk accordingly. One of the main benefits of unit trusts is reduction of the unsystematic risk by diversifying the investments.

Diversifiable Risk

Diversifiable risk is that portion of total risk that is unique to a firm or industry and does not systematically relate to the securities markets in general. For example, the management style of a firm may be a source of unsystematic risk for that firm.

Undiversifiable Risk

Undiversifiable (systematic) risk is that portion of total risk caused by factors that affect the prices of practically all securities traded in any given market. Changes in the economic, political, sociological environment that affect all securities are sources of the risk. For example, interest rate risk, and inflation risk are sources of undiverfiable risk which typically influence most securities. Nevertheless, some of the factors that are important in one securities market may not have the same degree of importance in other markets. For instance, the systematic price movements that corresponds to the undiversifiable risk in bond markets may be somewhat uncorrelated with the undiversifiable price fluctuations in a commodity futures exchange. Therefore, diversifying among different markets can further reduce the risk of the overall portfolio. This is the reason why general trusts that invest in a wider variety of assets globally usually have lower risk than growth trusts investing in a single region.

Other Risks associated with Unit Trusts

Risk due to concentration of investment

The concentration of unit trusts is defined in three ways: (1) The number of stocks or securities held in the portfolio ; (2) the concentration of investments in particular regions; (3) the concentration of investment in certain securities. The degree of concentration of a particular trust usually results from the managers' investment philosophy and the objectives of the trust. Aggressive managers tend to invest for higher growth and to run more concentrated portfolios. The risk undertaken by such portfolio will be higher because the unsystematic risk will not be minimized if the number of securities in the portfolio is too small. Also, such trust may not diversify among markets. In this case, if the particular market turns down, the concentrated portfolio is adversely affected. For instance, Hong Kong stocks were adversely affected during the Sino-British talks and the returns of portfolios with concentrated investment in Hong Kong suffered accordingly.

As the scope of investments is governed by the investment policy in the trust deed, fund managers may not have the discretion to invest in every area. Thus, managers cannot put the money in investment vehicles beyond those specified even if those investments can reduce the overall portfolio risk.

Exchange rate risk

Many trusts in Hong Kong are exposed to exchange rate risk because their portfolios have investments denominated in foreign currencies. If a foreign currency appreciates, holding assets in the foreign currency is beneficial to the investors and vice versa. For example, the extremely good performance of the Japanese trusts recently is partly due to the recent appreciation of the yen against the H.K. and U.S. dollars.

Risk due to instability of cash flows

Cash inflows and outflows at inappropriate times may increase the underlying risk of the trusts. Normally the sale of units is high when the market price of the investments in the portfolio is high. In this case, the managers are required to buy more securities at high prices. On the other hand, redemptions tend to occur when the market prices of the investments are low. In order to meet the liquidity needs, managers may have to sell the securities even if they are at low prices.

Performance -- Risk and Return

In theory, the higher return investors require, the more risk they have to bear. Unit trusts are no exception. A unit trust may have a lower return because the fund manager chooses a low risk level for the fund. Therefore, in evaluating the performance of unit trusts, merely focusing on the trusts' return is neither appropriate nor fair because the underlying risk of the trusts should be considered.

Performance Evaluation Approaches

Three major portfolio evaluation approaches which incorporate the risk level as well as return are widely used. They are Sharpe's Approach, Treynor's Approach, and Jensen's Approach. The formula for Sharpe's measure is given later in this chapter and the other two appear in Appendix 2. Sharpe's measure uses the standard deviation of portfolio returns as the measure of risk, whereas the latter two approaches employ beta (a measure of the systematic risk of the portfolio). In spite of the difference in risk measures, past studies in the U.S. generally show that the three measures give similiar results.

Past Studies Of Trusts' Performance in Hong Kong

The Unit Trust Association and some consultancy firms such as PFC Ltd have the performance evaluated on unit trusts performance in Hong Kong. The former prepares performance reports for sale while the consultancy firms provide the evaluations to their clients. In those evaluations, only rates of return are considered. Academics have conducted several studies evaluating the trusts' performance. Since many of the trusts in Hong Kong are diversified geographically in the Asian region, Europe, and other areas, it is very difficult to calculate an appropriate beta for the funds. Hence, the Sharpe's Index has been employed by these researchers.

Sharpe's Approach

1) The Sharpe's Index is given as follows:

$$S = \frac{R_{p,ave} - R_f}{SD} \qquad (6.1)$$

where
- S : Sharpe's Index
- Rp,ave : Average rate of return of the portfolio
- Rf : Risk-free rate
- SD : Standard deviation of rate of return for the portfolio

2) Rp,ave is the arithematic mean of the rates of return for several sequential periods. The rate of return for a specific period can be expressed as:

$$Rp,t = \frac{Dp,t + (Pt - Pt-1)}{Pt-1} \qquad (6.2)$$

where Dp,t : The total dividend per unit distributed by the fund during period t.
Pt : The price of a unit at the end of period t
Pt-1 : The price at the end of period t-1

3) In Hong Kong, the domestic saving rate was chosen as the risk-free rate because there is no Treasury Bill in Hong Kong.

Performance Evaluations

In this section, we illustrate some of the evaluation methods and the relationship between risk and return using the data of a past study.

Table 6.1 presents the annual rates of return for 31 Hong Kong trusts for the period 1981 - 1985. A list of the trusts appears in Appendix 3.

Since most of the funds in Hong Kong are quoted in foreign currencies and performance of the funds should be evaluated from the investors' stand point, the returns are recalculated in terms of H.K. Dollars using the exchange rate at the end of each year. The formula to convert the return in terms of H.K. Dollars is as follows:

$$R1 = \frac{Et\text{-}1 * (1 + R0)}{Et} - 1 \qquad (6.3)$$

where R1 : adjusted annual fund return in H.K. Dollar terms

Et-1 : exchange rate of H.K. Dollars against other currency at time t-1 as shown in Table 6.3

Et : exchange rate at t shown in 6.3

R0 : unadjusted annual fund return as calculated in Table 6.1

These adjusted rates of return are given in Table 6.2. The average annual returns and the standard deviation of annual returns for each fund in Table 6.1 and 6.2 are also presented in Figure 6.1 and 6.2, repectively.

By comparing Tables 6.1 and 6.2 and examining Figure 6.1 and 6.2, the following conclusions can be drawn:

(a) The average returns after exchange rate adjustments are higher. This occurs because the H.K. dollar depreciated during the period.

(b) All but three of the trusts have a higher risk level after adjustment for exchange rate changes. This shows that the exchange rate fluctuation increased the risk of the portfolios during this period of time.

(c) The general relationship between the return and risk tends to be positive.

(d) The risk of growth trusts on average is higher than that of the income trusts. The risk of the only general trust included in the study lies about midway between the growth and the income trusts. The risk levels as well as the rates of return of the two specialized trusts differ greatly depending on nature of the trust.

Table 6.4 presents exchange rate (in H.K. dollar terms) annual rates of return for some of the major stock indexes around the world. This information is used below in the evaluation of H.K. unit trust performance.

In Table 6.5, the aggregate return column represents the cumulative growth rate of the funds over 1981-85. This information was obtained from the Customer Information Sheet prepared by PFC Ltd. The average return column was extracted from Table 6.2 so the average returns reported here are adjusted for exchange-rate changes. Applying Sharpe's approach discussed previously to the data in Table 6.2 we obtain the figures on the 'Sharpe's Index' column.

Table 6.5 shows that the different evaluation methods provide markedly different performance rankings. If only average returns or aggregated returns are considered, all the top performers are Japanese trusts. On the other hand, if Sharpe's Index is used to meausre performance, four trusts, all of which are bond trusts, outperform the top Japanese trusts. Because it reflects both risk and return, the Sharpe's Index is the most desirable evaluation approach among those presented in the table. It should be noted, however, that ordinary investors would be unlikely to employ this measure because it is complicated.

Various people have previously investigated how well unit trusts have done by comparing the Sharpe's Index of the trusts with that of the Heng Sang Index which represents performance of Hong Kong stocks. However, this comparison is not objective enough to compare the unit trusts' performance with that of the market. One should investigate the trusts' objectives and investment regions so that one can pick out the most appropriate market index as the comparison reference.

In view of this, we try to identify the most appropriate market index for assessing each fund. Therefore, we choose the market index of the area (see Table 6.4) in which the fund emphasizes. We use the Nikkei Dow Jones Index for those funds with strong emphasis in Japan stocks, the Dow Jones Industrial Average for those with emphasis in U.S. securities, the Hang Seng Index for those in Hong Kong markets, the Australian All Ordinaries for those focusing on

Australia, and the Capital International Index for international funds investing broadly in world equity markets.

Referring again to Table 6.5, if Sharpe's index for the Heng Sang Index is used to represent the market for all funds, only four trusts perform worse than the market. However, when comparing the trusts' performance with Sharpe's index of the market index of the corresponding area, only six funds outperform the market.

Table 6.1

Fund Annual Rates of Return
(No Exchange Rate Adjustment)

Name	Currency	81	82	83	84	85	Average Return	Standard Deviation
Income Trusts								
SPDF	US$	- 3.82	33.93	4.34	- 0.33	16.24	10.07	15.34
SPSF	STG	0.41	35.37	11.44	6.10	- 1.48	10.37	14.87
SPYB	Yen	24.40	7.80	18.53	7.60	10.47	13.81	7.39
SPDB	DM	4.82	15.70	7.80	10.58	9.07	9.60	4.01
GIB	US$	- 6.40	18.10	-10.19	- 4.71	17.31	2.68	13.91
JCB	US$	11.35	27.41	2.65	1.86	35.47	15.75	15.07
WBT	US$	6.49	20.94	10.56	- 0.93	28.50	13.20	11.62
SCB	US$	4.71	14.99	7.60	5.30	37.11	13.94	13.58
Growth Trusts								
SPFE	US$	16.65	-13.97	39.98	- 8.67	32.83	13.36	24.14
SPNA	US$	- 8.82	13.60	19.75	-14.33	29.84	8.01	18.89
SPIG	US$	-18.09	- 6.00	18.96	-16.49	15.64	- 1.20	17.55
GHK	HK$	20.50	23.11	30.74	2.78	33.41	12.86	23.43
GJF	US$	18.47	- 0.70	49.08	-10.76	38.67	18.95	25.34
GNA	US$	- 6.57	3.58	16.65	-15.61	12.45	2.10	13.32
GAT	US$	-54.18	-35.92	24.80	- 0.10	-15.82	-16.24	30.71
GTA	US$	-26.51	-27.07	49.40	-35.75	13.00	- 5.39	35.98
GTHK	US$	7.78	-16.57	34.16	4.75	- 5.04	4.94	18.98
JJT	Yen	28.66	5.45	57.36	11.39	3.38	21.25	22.50
JHK	US$	1.82	-33.39	0.00	8.00	38.21	2.93	25.49
JPS	US$	9.01	-25.85	42.11	- 7.27	46.88	12.98	31.35
JPI	US$	8.93	3.83	49.84	6.15	60.92	25.93	27.22
JET	HK$	18.45	-28.89	40.55	- 5.71	14.48	7.78	26.26
OHK	HK$	17.32	-25.72	19.42	35.59	40.30	17.45	26.13
HPJ	US$	11.90	- 3.28	61.14	7.19	55.51	26.64	29.53
WJT	US$	10.12	9.24	59.46	10.91	28.83	23.71	21.58
SIT	US$	- 8.28	14.99	19.10	10.18	49.84	13.08	24.44
SJF	US$	20.64	- 1.96	56.68	1.55	46.59	24.70	26.29
SAF	US$	2.75	-22.60	19.22	25.95	33.68	11.80	22.36
General Trust								
JIT	US$	-16.51	0.00	40.59	- 7.78	44.97	12.23	28.49
Specialized Trusts								
JSC	Yen	7.96	11.23	81.97	17.14	0.54	23.77	33.08
ODC	US$	-18.07	-17.17	7.33	-16.23	5.47	7.73	12.94

Source: Tse Ying-tin, Wong Chi-wai, "The performance of Unit Trust in Hong Kong", MBA Business Research Project, The Chinese University of Hong Kong, 1986.

Table 6.2

Funds Annual Rates of Return
(After Exchange Rate Adjustment)

Name	Currency	81	82	83	84	85	Average Return	Standard Deviation
Income Trusts								
SPDF	US$	4.47	52.95	24.82	0.37	16.24	19.83	20.86
SPSF	STG	-10.37	31.05	19.08	-14.00	21.68	9.49	20.32
SPYB	Yen	27.82	15.05	44.42	- 0.15	38.74	25.18	18.06
SPDB	DM	0.28	25.14	13.88	- 4.41	39.22	14.82	17.92
GIB	US$	1.94	34.87	6.58	- 4.04	17.31	11.33	15.30
JCB	US$	21.28	45.51	22.80	2.54	35.47	25.53	16.20
WBT	US$	16.47	38.12	32.26	- 0.23	28.50	23.17	15.05
SCB	US$	14.05	31.32	28.72	6.05	37.11	23.45	12.92
Growth Trusts								
SPFE	US$	27.05	- 1.75	67.45	- 0.03	32.83	23.51	30.26
SPNA	US$	- 0.69	29.73	43.25	-13.73	29.84	17.68	23.83
SPIG	US$	-10.79	7.35	42.31	-15.90	15.64	7.72	23.24
GHK	HK$	20.50	23.11	30.74	2.78	33.41	12.86	23.43
GJF	US$	29.03	13.40	78.34	-10.16	38.67	29.67	32.79
GNA	US$	1.76	18.29	39.55	-15.02	12.45	11.40	20.18
GAT	US$	-51.82	-36.41	37.76	- 7.51	-30.96	-17.80	34.89
GTA	US$	-22.72	-16.71	78.72	-35.30	13.00	3.40	45.69
GTHK	US$	17.39	- 5.18	60.49	5.49	- 5.04	14.63	27.27
JJT	Yen	32.20	12.55	91.74	3.37	29.52	33.88	34.49
JHK	US$	10.90	-23.93	19.63	8.76	38.21	10.71	22.58
JPS	US$	18.73	-15.32	70.00	- 6.62	46.88	22.73	35.86
JPI	US$	18.64	18.58	79.25	6.90	60.92	36.86	31.38
JET	HK$	18.45	-28.89	40.55	- 5.71	14.48	7.78	26.26
OHK	HK$	17.32	-25.72	19.42	35.59	40.30	17.45	26.13
HPJ	US$	21.88	10.46	92.77	8.64	55.51	37.86	36.00
WJT	US$	19.94	24.75	90.76	11.69	28.83	35.20	31.71
SIT	US$	- 0.10	31.32	42.48	- 9.55	49.82	22.80	26.27
SJF	US$	31.40	11.96	87.43	2.26	46.59	35.93	33.52
SAF	US$	11.90	-11.61	42.62	26.84	33.68	20.69	21.26
General Trust								
JIT	US$	- 9.07	14.20	68.18	- 7.13	44.87	22.21	33.65
Specialized Trusts								
JSC	Yen	10.93	18.71	121.72	8.70	25.96	37.20	47.73
ODC	US$	-10.77	- 5.41	28.40	-15.64	5.47	0.41	17.50

Source: Tse Ying-tin, Wong Chi-wai, "The Performance of Unit Trust in Hong Kong" MBA Business Research Project, The Chinese University of Hong Kong, 1986.

Figure 6.1

The Average Annual Returns and The Standard Deviation of Annual Returns for Each Fund in Table 6.1

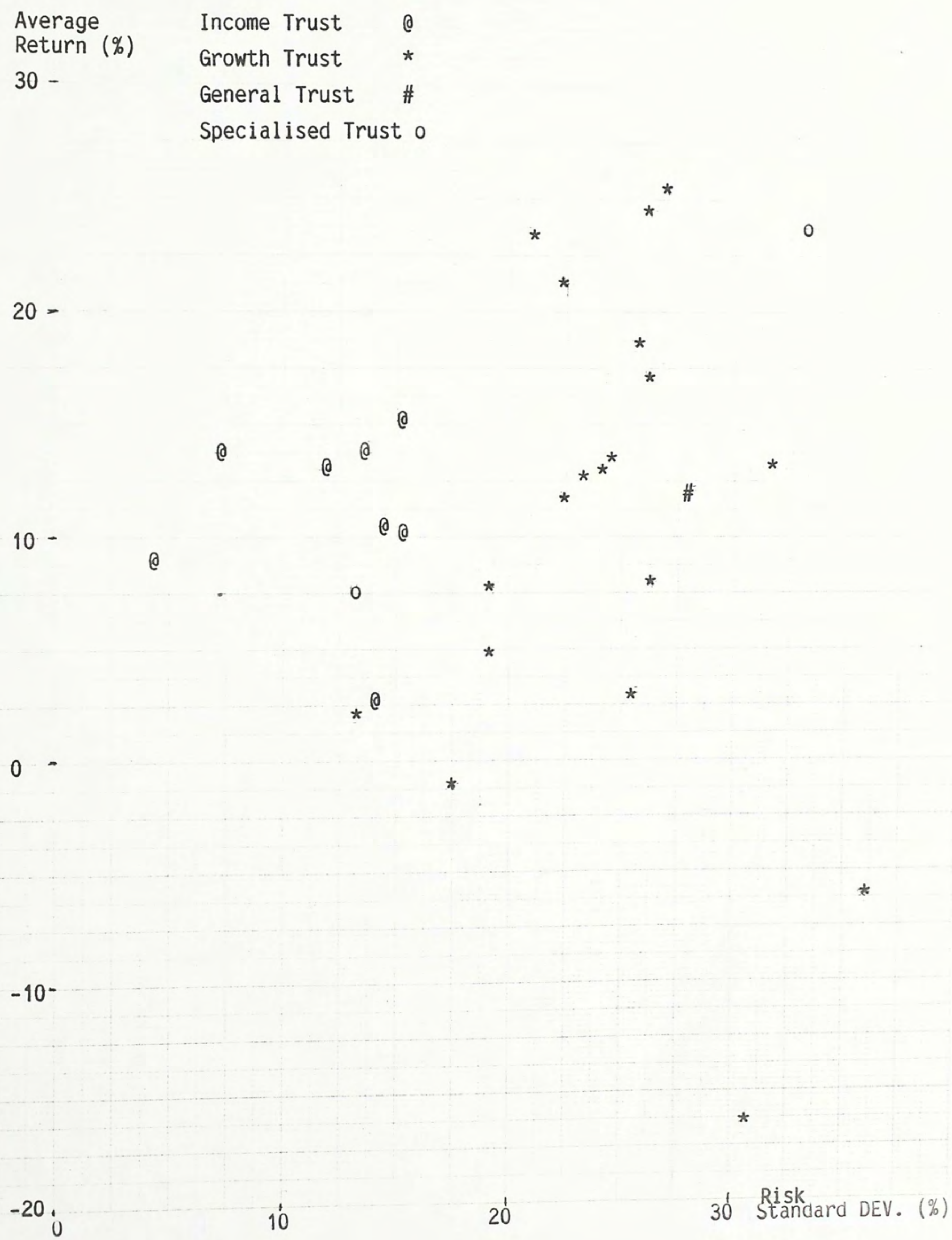

Figure 6.2

The Average Annual Returns and The Standard Deviation of Annual Returns for Each Fund in Table 6.2 (Except one with Negative Average Return)

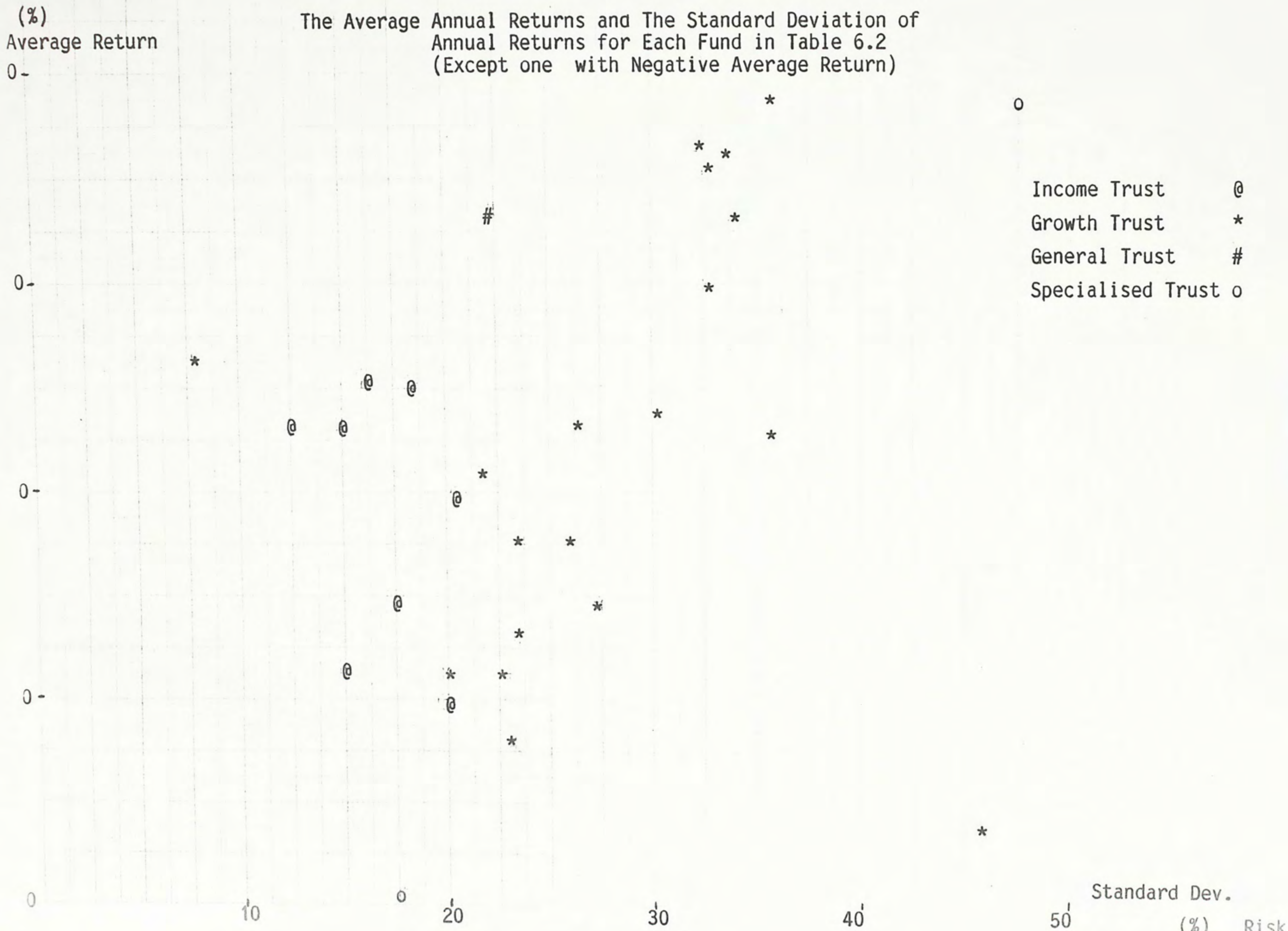

Table 6.3

Performance of H.K. Dollar Against Other Currrencies

Currency	1980	1981	1982	1983	1984	1985
US Dollar	19.18	17.61	15.42	12.89	12.80	12.80
Japanese Yen	3994	3887	3642	2989	3221	2571
Sterling	8.23	9.22	9.51	8.90	10.98	8.89
Deutsche Mark	38.04	39.76	36.76	34.81	40.27	31.55
Austrlian Dollar	16.53	15.72	15.84	14.35	15.50	18.90

(100 units of Hong Kong Dollar against other currencies)

Source: Data extracted from the Hong Kong Economic Journal, various issues.

Table 6.4

Exchange Rate Adjusted Annual Return & Risk of

Major Stock Market Indices

Index	1981	1982	1983	1984	1985	Ave	Standard Deviation
N.Y. Dow Jones	-1.00	36.59	43.88	-3.06	27.66	20.81	21.643
Hang Seng Index	-4.60	-44.24	11.63	37.20	45.99	9.20	36.020
Nikkei Dow Jones	10.92	11.38	50.38	8.25	42.33	24.65	20.051
Capital Int'l	0.30	20.91	41.75	2.46	33.40	19.76	18.364
All Ordinaries	-10.56	-19.08	76.27	-13.30	13.37	9.34	39.409

Source: Data extracted and rearranged from the Hong Kong Economic Journal, various issues, and Customer Information Sheet produced by the Personal Financial Consultant Ltd. The data has been adjusted using equation 6.3.

Table 6.5

The ranking of fund performance for the period 1981-1985

Name	Investment Area	* (%) Aggregate Return	Rank	** (%) Ave Return	Rank	Sharpe's Index	Rank
HPJ	JAPAN	+201.94	1	37.86	1	0.8511	8
SJF	JAPAN	+180.47	2	35.93	3	0.8566	7
WJT	JAPAN	+170.77	3	35.19	4	0.8823	6
JPI	JAPAN	+144.47	4	36.86	2	0.9446	5
JJT	JAPAN	+143.65	5	33.88	5	0.7732	9
GJT	JAPAN	+100.55	6	29.67	6	0.6905	10
SCB	---	+ 86.63	7	23.45	10	1.2569	1
OTH	HK	+ 85.83	8	17.45	18	0.3918	19
SPYB	---	+ 83.94	9	25.18	8	0.9943	4
GHK	HK	+ 70.54	10	12.86	21	0.2411	22
JCB	---	+ 70.48	11	25.53	7	1.1302	2
SIT	INT'L	+ 70.13	12	22.79	12	0.5930	13
WBT	---	+ 69.00	13	23.12	11	1.0568	3
SPFE	---	+ 66.14	14	23.51	9	0.5385	14
JPS	JAPAN	+ 55.51	15	22.14	14	0.4328	17
SPDB	---	+ 52.20	16	14.82	19	0.4246	18
SPSF	---	+ 50.44	17	9.49	25	0.1119	25
SAF	HK	+ 49.57	18	20.69	15	0.6338	11
JIF	INT'L	+ 49.34	19	22.21	11	0.4456	15
SPDF	---	+ 48.55	20	19.83	16	0.6045	12
SPNA	USA	+ 35.28	21	17.68	17	0.4392	16
GIB	---	+ 14.65	22	11.33	23	0.2690	21
GTHK	---	+ 11.75	23	14.63	20	0.2720	20
GNA	USA	- 0.52	24	11.40	22	0.2072	23
JHK	HK	- 3.10	25	10.71	24	0.1550	24
SPIG	INT'L	- 13.85	26	7.72	26	0.0218	26
ODC	---	- 32.94	27	0.41	28	-0.3888	28
GTA	AUS	- 40.65	28	3.40	27	-0.0835	27
GAT	AUS	- 71.61	29	-17.79	29	-0.7166	29
Market Index							
CII	INT'L	+ 58.78		19.76		0.6834	
NYDI	USA	+ 60.67		20.81		0.6284	
HSI	HK	+ 18.92		9.20		0.0550	
AAOI	AUS	+ 43.30		9.34		0.0590	
NDJI	JAPAN	+ 89.76		24.65		0.8697	

--- : No geographical investment area emphasized

Source: * Personal Financial Consultants Ltd
** Tse Ying-tin, Wong Chi-wai, "The performance of Unit Trusts in Hong Kong", MBA Business Research Project, The Chinese University of Hong Kong, 1986.

CHAPTER VII

RECENT DEVELOPMENTS AND FUTURE TRENDS

Unit trusts are one of the fastest developing businesses in Hong Kong. In order to shed some light on the ever-changing world of the fund industry, this chapter discusses recent developments and possible future trends in this field. We categorize the developments into four groups; namely, products, financial institutions, measures of performance and promotion.

Products

Products in the fund market have become more and more diversified during the last two years. The products recently introducted include money market funds, funds of funds and umbrella funds. We discuss the nature, characteristics and current situation of these funds and also professionals' opinions about them in the following sections.

Money Market Funds

A money market fund is a form of mutual fund specializing in the investment in money and capital market instruments. The instruments usually include fixed- and floating-rate notes, certificates of deposit and commercial paper. According to Securities Commission regulations, at least 20 per cent of a money market fund must be invested in "cash" investments. The cash portion of the fund would mainly take advantage of call rates, the interest rate available for leaving large sums on deposit overnight, and interbank rates, the rate banks charge each other to borrow money.

These funds can generate favorable returns because large sums of money can earn better interest rates than small sums. Also, these funds allow small investors to access the money markets. For instance, it takes a minimum of $5 million to take advantage of interbank rates but an investor now needs only $50,000 to get the same rate by investing in a money market fund.

Up to March, 1987, five money market funds have been established in Hong Kong. Manufacturers Hanover Trust, Jardine Fleming Investments, Schroders and Kleinwort Besons offer Hongkong dollar-based money market funds, and Chase Manhattan has a U.S. dollar fund.

There are basically two types of money market funds; accumulation and distribution. In the accumulation or roll-up fund, such as Manufacturer Hanover Trust's, interest accrued daily remains in the fund and the portfolio's yield is reflected in the unit price. In the distribution type fund, such as

Schroder's , the unit price remains constant, usually at $1, and interest accrued daily is put in the investor's account and paid out quarterly or at redemption.

Currently, one per cent per annum is the standard fee charged for investing in money market funds: a 0.75 per cent manager's fee plus a 0.25 per cent trustee's fee. Similiar to a bank savings account, a money market fund has high liquidity and can be redeemed on very short notice.

In the U.S., money market funds have posed a competitive threat to retail banks. Due to the restrictions on the saving rates that can be offered by retail banks, money market funds have successfully gained a large share of the general public's deposits.

However, this phenomenum has not happened yet in Hong Kong. As a result of the narrowing of the interest spread between saving deposits and the longer-maturity papers, the allure of the money market fund has been diminished while the risk of capital loss has increased. In fact, the shift in interest rate patterns has caused some of the authorized money market funds like that of Citicorp International and Indosuez Asia to postpone formal launching.

Although money market funds in Hong Kong have not been particularly successful to date, they still have substantial potential and may grow rapidly if interest rate patterns change in the future.

Fund of Funds

Due to the restrictions imposed by the Code on Unit Trust and Mutual Funds, 'fund of funds' have appeared only very recently in Hong Kong. At the end of 1986, the Commissioner of Securities finally approved the estabilishment of this type of fund in Hong Kong. Amendments have been made to Paragraph 47 of the Code to allow unit trusts to invest in other trusts.

A Unit Portfolio Management Fund (UPMF), or more commonly known as a fund of funds, is a fund that invests primarily in other funds. In the U.K., UPMFs may only invest in in-house funds. However, this restriction does not apply in Hong Kong, where the Securities Commission gave UPMFs freedom to buy units in any authorised funds, including those of another management group. Moreover, up to 20%[5] of total assets may be invested in non-authorized funds subject to the approval of the Commission. A UPMF must invest in at least five funds and no single fund should account for more than 35% [5] of the UPMF's total assets.

The amended code also includes specific

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[5]Hong Kong Government. Hong Kong Code on Unit Trusts and Mutual Fund, Amendments to the Code, June 1986.

instructions with regard to levying preliminary charges and management fees. On the one hand, if the UPMF invests in funds of the same management group, all preliminary charges must be waived. On the other hand, if it invests in funds of another management group, any charges must be clearly stated. In either case, management fees must be specified clearly in the prospectus. In addition, under the Code, the UPMF's management company is not allowed to take a rebate on any charges or fees levied by an underlying fund or its manager.

The UPMF has a special appeal to smaller investors because it tends to be less risky than regular unit trusts. With assets invested in a variety of vehicles, a fund of funds taps the expertise of several different fund managers. Its performance hence depends upon neither a single market nor a single point of view. Of course, UPMF does have its own drawbacks. The dispersal of assets among several funds can make a UPMF less profitable than an ordinary unit trust invested in the right market at the right time. Nevertheless, fund of funds are especially suitable for those investors who have no idea which markets will grow and prefer stablity over possible dramatic growth.

Many of Hong Kong's best-known fund managers are expected to apply for UPMF authorizations following the amending of the Code. In fact, Gartmore has already launched Gartmore Managed Fund which only invests in the company's funds, while PFC has launched its International Portfolio Trust which invests in other companies' funds.

Because of its low risk nature, UPMFs are expected to be especially popular among more conservative investors.

Umbrella Funds

An umbrella fund is very similiar to a UPMF. In both cases, the portfolio contains other units of other funds. In other words, both of them invest in other funds. The difference between them lies in the aspect of decision making. In a UPMF, the fund managers have absolute power to adjust the content of the portfolio unless such an action would violate the trust deed. In an umbrella fund, however, the investor himself can switch his funds into another fund within the umbrella whenever he likes. The umbrella fund has the advantage of offering freedom, and hence flexibility, to investors so that they can make their decisions according to their own preferences and information. But this benefit is achieved at the expense of the professional fund managers' expertise.

Wardley's Global Selection Fund, Scimitar Worldwide Selection Fund and Chase Manhattan's Unit Trust are some of the examples of this type of fund. Given the stability and flexibility provided, it is believed that umbrella funds will become a rather popular investment instrument in the forseeable future.

Money market funds, UPMFs and umbrella funds are only some of the recent developments in the unit trust industry. It is widely agreed that other new products will be introduced in the market. The major directions will be towards more sophistication and more convenience (for example, a touch-tone fund in which one can buy or sell his holding of units by simply dialing a telephone number).

Financial Institutions

With global deregulation of financial institutions, some people expect that the so called 'financial supermarket' will appear to provide the public with a full spectrum of financial services including accounting and tax advice, various types of insurance, loans and mortgages, and also investment management. Unit trusts would likely be one of the products offered. Whether this is the future trend or not, more financial institutions, like insurance companies and commercial banks, will enter the fund market.

In the following paragraphs, we provide an overview concerning movements of both life insurance companies and banks in the fund market.

Life Insurance Companies

Due to the nature of their business, life insurance companies generally possess large amounts of investment funds and a very good reputation for stability and reliability. Investment experience and reliability are probably two of the most crucial elements for success in managing and marketing small investor's instruments like unit trusts. It is not surprising, therefore, that some of the reputable life insurance companies with long operating history in Hong Kong are going to enter the fund market. Actually, Prudential and National Mutual are both applying to launch unit trust funds while some of the others like Manual Life, New Zealand Insurance and Connecticut are actively studying the feasibility of estabilishing similiar funds. This is, however, not a new idea. Similiar developments have appeared in North America where many investment products are provided by insurance companies.

The unit trusts offered by these insurance companies involve different combinations of bonds, currencies and stocks of different countries. Investors, however, have to bear the risks. Therefore, they can be considered as pure investment instruments, in contrast with traditional insurance products which combine the functions of investment and insurance. The particular insurance companies that have shown an interest in this field are all international ones with their own independent professional investment departments.

The concept of insurance companies offering investment products is somewhat controversial. Some insurance professionals feel that offering financial instruments like unit trusts is a degradation of the insurance business. Their argument is that insurance companies should provide customers with security and protection, but not assist the customers to invest. They also think that insurance companies should promote their business by upgrading their service, not by providing products other than insurance. The past three years' experience in the U.S. has been cited as an example. In the U.S. insurance companies sold many policies with a high investment component and even some financial instruments like unit trusts. However, due to the fall in interest rates and the changing investment environment, small investors now find that many of these products have no guaranteed return and are earning lower than expected returns. Consequently, the sales of these products have dramatically declined.

On the other hand, some people believe that the launching of unit trusts will be a major trend in the insurance business, especially for those companies which have just arrived in Hong Kong or which intend to expand their business in Hong Kong. They argue that if investors understand the nature of their policies and the investment instruments, there should not be any harm to the insurance companies' image of reliability. As this kind of investment is expected to generate a higher rate of return than traditional insurance, more of the general public are expected to accept this type of investment.

Banks [6]

To date, the unit trust industry has developed via special investment management institutions (for example, Gartmore, GT Management, Britania, Thorton), and merchant bankers (for examples, Wardley, Jardine Fleming, Schroder). Initially, commercial banks steered clear of the investment sector with the exception of serving high net-worth individuals in their investment departments. This is basically the case at the present time.

Nevertheless, the situation is changing and the commercial banks have modified their strategies in the investment sector. In Hong Kong, we have seen the emergence of Bank of America, Citibank, Indosuez, Royal Bank of Canada and lately Manufacturers Hanover Trust and Chase Manhattan Bank in the unit trust industry.

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[6] The contents in this section are mainly extracted from: "Briefs for Treasurers and Investors." Asian Finance, 15 October, 1986, p.8, p.12.

Standard Chartered has gone a step further and has formed a specialised, autonomous investment institution, Scimitar Asset Management, to run its unit trust business and other investment services. Money market funds and other kinds of unit trusts have become the new competitive arena.

Commercial banks have advantages in entering the fund business:

(1) The current and saving accounts holders of the banks are potential unit trust investors. By making use of their data banks, the banks can develop market share very quickly.

(2) The vast networks of branches are competitive strengths of the banks. The network offers the banks many opportunities to keep in touch with potential customers and the public.

(3) The image of the banks is stronger than those of the specialised investment institutions, particularly in terms of reliability, in most local small investors' minds.

However, banks also face competitive disadvantages:

(1) Their employees have no experience in operating this kind of business.

(2) The large branch network of banks is also a weakness. Since the customer base of the bank is made up of various kinds of people, it is very difficult for a branch manager and his staff to

decide whether to suggest the bank's unit trust investment option to a particular customer or to leave the customer with a lower risk, lower yield deposit. If the customer thinks that the bank has given them poor advice and has caused them to lose money, the bank is likely to lose the customer entirely.

(3) Banks still do not have enough experience in unit trust operations. Moreover, it is very difficult for the banks to attract experienced staff which is in short supply. Many of the larger banks are constrained from competing aggressively on the salary front by their existing staff salary structure. Therefore, the more entrepreneurial investment managers tends to remain outside the banking sector of the industry.

(4) Banks only manage a few trusts at present while specialised investment institutions manage a much wider range of funds. Therefore, investors have more choices in unit trust investment with the specialised institutions.

(5) Investment advisors and other intermediaries tend to recommend the specialists because of their past performance and also because their promotion materials tend to be more innovative.

(6) The specialised institutions can seize marketing opportunities much quicker than the banks. For

example, the specialists have already offered life insurance / pension policy units, portfolio management services, savings-type investment accounts.

To conclude, because the potential of the unit trust industry is not clear and because the banks do have large customer bases, more and more banks are expected to go into the business. Although it seems that banks are still inferior in this competitive environment compared to the specialist investment institutions, their situation will improve when they widen the scope of their investment management, give more autonomy to their investment management entities, and streamline their decision-making process in the future.

Measurement of Unit Trust Performance

In 1986, the Personal Financial Unit Trust Index, the first index indicating the performance of Hong Kong unit trusts, was estabilished by Personal Financial Consultation Ltd.. According to Mr M.K. Chan, the Managing Director of PFC, this index is intended to give investors a general indicator of the performance of unit trusts in various markets and areas. The index should also reflect individual fund managers' investment approaches.

The index is based on the performance of 33 funds investing in Europe, America, the Far East and in gold. The classifications follow those adopted by Morgan Stanley's Capital International Index. The Far East Region includes investments in Japan and the Far East; the American Region includes investments in the U.S. and Canada; the Europe Region includes investments in Britian, Germany, France and other European countries. In addition, the index also includes investment in gold. The index is also subdivided into sectorial indices like the European Sectorial Index, the Far East Sectorial Index and so on, to indicate the performance of investments in different markets.

Some fund managers consider the index to be good publicity for attracting more investment to unit trusts. They also feel that the index can be treated as a reference point for evaluating investment performance. Others, however, do not think so. A fund manager said that one of their offshore funds has been selected for inclusion in the index but actually the fund was setup for tax reasons and, therefore, should be treated as an exceptional case. It can be very misleading when investors judge the performance of a fund in this area, simply based on the index. Moreover, he pointed out that some of the selected funds are actually not very popular and in fact should not have been chosen. He also suggested that it is more appropriate for the Unit Trust Association rather than a unit trust promotion company to set up such an index.

Another fund manager said that there is only one fund involved in some of the areas and it is doubtful whether the index actually reflects the true picture of unit trust investments in such an area.

Whether the index is an ideal measure of performance is a controversial topic. Nevertheless, the index indeed provide some general reference for the public. Besides, as we will see later, UTA also provides statistics on the performance of various individual funds. It would be a healthy phenomenum to see more of this type of information in the future.

Promotion

Unit Trust Association

The Unit Trust Association (UTA), a self-regulatory body constituted by the major unit trust companies in Hong Kong, became a legal entity in May of 1986. The first association of this type was set up in the U.K. and similiar organizations have been set up in countries where unit trusts are popular.

The Association is governed by a ten-member executive committee representing a cross-section of the industry. Its formal recognition is the culmination of almost a decade of close cooperation between the leading investment managemnt groups in Hong Kong and the Securities Commission.

The Association's prime concern is to popularize unit trusts and mutual funds among potential investors. In addition, the Association is going to formulate standards of practice, acounting norms and special safeguards for particular type of funds. Its nature is very similiar to that of the Association of Tourism.

On behalf of UTA, the Wyatt Company is compiling standardised performance figures from January 1, 1980 on, which would enable investors to judge and choose the funds suitable to their needs. They will publish handbooks to provide information to investors and also monthly statistics to give unbiased figures on the performance of various funds. All this is part of what UTA calls 'public education'.

Another objective of setting up such an organization is to obtain more bargaining and political power through the union of so many investment management companies. As a legal entity, the association can deal with government bodies, especially on legislative matters.

However, an experienced executive in this field complained that UTA is not very successful. In his opinion, UTA has not yet performed any meaningful tasks and does not possess any bargaining power at all. He believes that the probable cause for this is that most of the committee members in UTA are too busy to get the necessary work done. Nevertheless, he feels that the situation will improve gradually in the future.

However, we feel that the formation of UTA is undoubtedly a very important step in promoting and monitoring the unit trust industry in Hong Kong.

Consulting Subsidaries

Personal Financial Consultants Ltd., a subsidary of Jardine Fleming, is one of the most successful investment consultant companies in Hong Kong. Its major business is to introduce appropriate investment instruments to clients. A very large proportion of its business in the recent years has involved unit trusts.

Although PFC generally recommends virtually every fund available in Hong Kong depending on the particular needs of their clients, some fund managers believe that PFC tends to favor the funds offered by its parent organization and, therefore, has brought Jardine Fleming a substantial amount of profits.

Most fund managers agree that as the number and variety of funds increase, the demand for investment consultancy will be even greater. Because of the direct benefit of earning commissions and the indirect benefit of generating revenues for parent companies, investment consultancy subsidaries is likely to be a future trend in the fund industry.

More Emphasis On Non-English Speaking Chinese

Due to the increasing number of funds, the competition in this market has become more intense. Most investment companies provide very good management services to their clients. Apart from the funds' performance, marketing efforts are likely to be critical in gaining more business.

Traditionally, the major target customers of unit trust have been those foreign people and local English speaking professionals. However, the market for foreigners is nearly saturated. Instead, many investment companies have discovered that there is a large potential market among the local Chinese. Consequently, more companies have started to print Chinese brochures and pamphlets, and also to train marketing staff who can speak fluent Cantonese. It is generally agreed that local non-English speaking Chinese will be the major target markets in the coming years.

CHAPTER VIII

CONCLUSION

Generally speaking, a unit trust is a very convenient investment instrument in modern society. Apart from the benefits of diversification of investments and portfolio management, a unit trust also has the advantages of accessing more markets and achieving economies of scale in investing. While management fees, spread of prices and less control over investments are possible drawbacks, unit trusts are generally agreed to be a very handy way of investing, especially for small investors.

Unit trusts have become more and more popular investment instruments all over the world and this is particularly true in Hong Kong. Due to fundamental environmental factors like a favourable tax system, well-estabilished legal and telecommunication systems, and lack of capital controls, together with other economic, sociological and psychological factors, the unit trust industry in Hong Kong has grown at an extremely high rate. Of course, the promotion efforts of the investment companies and the contribution of some investment consultancy firms and UTA should not be disregarded.

There are many things that a small investor should clarify and take into consideration before he makes up his mind to invest in a unit trust. Some of them are the contents of the trust deed, the relationship between the investment company and the trustee, the calculation of unit prices and other charges, procedures for distribution and redemption and investment restrictions, management and performance of the funds. Among these factors, fund management is probably the least understood by the general public. A whole chapter of this report was therefore devoted to the various aspects of fund management. Different management approaches and philosophies are adopted by different fund managers. Fundamental analysis, technical analysis, the 'top-down' approach, and the 'bottom-down' approach are employed in different combinations in actual practice. However, it is generally agreed that investment experience together with so called 'market feeling' usually play a more important role than theoretical approaches and techniques.

Apart from the day-to-day management of the portfolios, another major responsibility of fund managers are to promote the funds. They frequently have to meet their potential clients to recommend the funds. They also write articles for newspapers and help design advertisements.

Risk appears to be an important element of investing in unit trusts that has long been neglected by small investors. Most small investors only pay attention to the returns but forget that they bear different level of risks when investing in diferent funds. Inflation, fluctation in interest rates and exchange rates, instability of cash flows, management's capability and many other factors influence the uncertainity of the return, or so called risk. Generally speaking, a higher expected return requires a more risky investment. Therefore, in judging the performance of different funds, small investors should not just compare returns, but should also take risk into consideration.

There are many evaluation approaches for measuring the performance of different funds. Sharpe's Approach is undoubtedly one of the most widely employed methods. In Chapter Six of this paper, we evaluated the performances of 31 Hong Kong unit trusts using different approaches. The findings show that ranking by return only is significantly different from ranking by Sharpe's Approach. Therefore, small investors should pay more attention to risk when they decide which fund is the most appropriate for them.

The unit trust industry is growing fast and it is an ever-changing business. Many new types of funds like money market funds, funds of funds and umbrella funds have been introduced in the past few years. More new products are likely to be developed to meet investors' needs in the future. More finanical institutions like insurance companies and commercial banks have shown an interest in this industry and, in fact, some of them have estabilished their own subsidaries to launch funds.

In a nutshell, the unit trust industry in Hong Kong has an extremely high growth potential. Product innovation and marketing orientation will be the major emphasis of investment companies in the coming years. Further development of the fund market will definitely be beneficial to financial markets and small investors.

APPENDICES

Appendix 1

SCHEDULE I

Revenue Account of the Trust for the year ended . . .

Revenue (Note 1)

Dividends and interest
Sub-underwriting commission
Other revenue

Expenses

Management company's annual fee
Remuneration of trustee
Auditors' remuneration
Interest
Safe custody fees and other expenses

Net Income

Distribution

Add: Income received on units issued (Note 2)
Subtract: Income paid over by trustee on units cancelled (Note 3)
Add: Undistributed income brought forward
Total income available for distribution
Interim distribution of . . . per unit
Final distribution of . . . per unit
Undistributed income carried forward

Notes:

1. All Revenue items may be shown after deducting withholding tax, if any. If this has been done, the fact should be disclosed.
2. "Income received on units issued" is the amount of accrued income which the amount paid over to the trustee for inclusion in the deposited property was deemed to contain.
3. "Income paid over by trustee on units cancelled" is the amount of accrued income which the amount paid over by the trustee against units cancelled was deemed to contain.
4. Comparative figures for the previous year must be stated.
5. If capital gains are distributed, it must be made clear how much of the distribution consists of such gains.

The total distributions in respect of the year should be stated on a per unit basis, as follows:—

Gross distribution in respect of the year ended . . .	*Tax, if any, withheld on these gross distributions*	*Net distributions*

SCHEDULE II

Accounts of the Management Company relating to Transactions in Units and the Management of the Trust for the year ended . . .

A Issue and cancellation of units

Proceeds of sale of new units
Subtract: Amount paid over to trustee for inclusion in deposited property
Add: Amount paid over by trustee against unit cancelled
Subtract: Cost of cancelled units
Gross profit on issue and cancellation of units

B Trading in units

Proceeds of units sold
Subtract: Cost of units bought
Add/Subtract: Increase/decrease in value of stock of units, valued at cancellation price
Distributions on units held
Gross profit on trading in units

C Profit and loss account

Gross profit on issue and cancellation of units
Gross profit on trading in units
Management company's annual fee
Refunds of brokerage charged to the trust and reallowances of other types on purchases charged to the trust
Other income
Subtract: Remuneration of trustee
Subtract: Commission
Subtract: Cost of advertising and publicity
Subtract: Other expenses

Net Profit before Taxation

Notes:

1. These Accounts should cover the same period as the Revenue Account of the Trust.
   It is recognised that this will not be possible to comply with if the Management Company's Accounts are for a different period to that of the trust. However, the Accounts must coincide as far as possible.
2. Where the management company has more than one trust under management, expenses incurred on behalf of the company's trusts as a whole must be apportioned by some method which the management company and its auditors consider equitable.
3. If any connected persons of the management company have become entitled to profits which derive from transactions in units or from the management of the trust, those persons must be named and the profit to which each such person has become entitled must be disclosed.
   If the management company, or any other person acting on its behalf or with its permission, has:—
   (i) acquired or disposed of any securities, for the account of the trust, otherwise than through a recognised stock exchange, or;
   (ii) disposed of units at a price lower than the issue price then current, or;
   (iii) acquired units at a price higher than the cancellation price then current;
   it must be disclosed that this has been done and to what extent. The management company is at liberty to append explanations.

Appendix 2

Other Evaluation Methods

Treynor's Approach

This portfolio performance measure indicates the rate of return earned above the risk-free rate in relation to systematic risk during a designated time period as follows:

$$Ti = \frac{Ri - RFR}{Bi} \qquad (1)$$

where

- Ti : Treynor portfolio performance measure for portfolio i during a designated time period
- Ri : average rate of return for portfolio i during a given time period
- RFR : average rate of return on a risk-free investment during a specified time period
- Bi : beta of the portfolio

Jensen's Approach

This measure is based upon the security market line (SML) of the capital asset pricing model (CAPM). The basic version of the SML is expressed by the equation:

$$E(rp) = Rf + (E(rm) - Rf) Bp \qquad (2)$$

Appendix 2 (cont'd)

where

E(rp) : expected return of a portfolio

Rf : risk-free interest rate

E(rm) : expected return of a market index

Bp : beta of a portfolio

If the equation is empirically valid. The equation can be stated in empirical form as:

$$\overline{rp} = \overline{Rf} + (\overline{Rm} - Rf) Bp \qquad (3)$$

Jensen's approach to evaluate portfolio performance involves two steps. First, using the equation (3), the return of a given portfolio is calculated. Second, the actual realized return of the portfolio is compared with the calculated or predicted return. The greater the excess of realized return over the calculated return, the better the performance of the portfolio.

Appendix 3

Index and Trust Abbreviation List

Company	Unit Trust	Abbreviation
Save & Prosper	Far Eastern Fund	SPFE
	North American Fund	SPNA
	International Growth fund	SPIG
	Dollar Fixed Int. Fund	SPDF
	Sterling Fixed Int. Fund	SPSF
	Yen Bond Fund	SPYB
	Deutschemark Bond Fund	SPDB
Gartmore	International Bond Fund	GIB
	HK Pacific Unit Trust	GHK
	Japan Fund	GJF
	North American Trust	GNA
	Australia Trust	GAT
G.T. Management	Australia Trust	GTA
	Asean HK Growth Fund	GTHK
Jardine Fleming	Currency & Bond Fund	JCB
	International Trust	JIT
	Japan Trust	JJT
	Hong Kong Trust	JHK
	Pacific Income Trust	JPI
	Pacific Securities Trust	JPS
	Eastern Trust	JET
	Japan Small Company Trust	JSC
N.M. Rothschild	Old Court Dollar Commodity Tr	ODC
	Old Court Hong Kong Fund	OHK
Hambro-Pacific	Japan Fund	HPJ
Wardley	Bond Trust	WBT
	Japan Trust	WJT
Schroders Asia	International Trust	SIT
	Japan Fund	SJF
	Asian Fund	SAF
	Currency & Bond Fund	SCB

Index	Abbreviation
New York Dow Jones	NYDI
Hang Seng Index	HSI
Nikkei Dow Jones Index	NDJI
Captal International Index	CII
Australian All Ordinaries	AAOI

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